

"Putting a Leash on Your Lease"

by Joe Hadzima

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Maybe the real estate market really is recovering.

In the past three weeks, among the usual calls I receive regarding financing, licensing, stock options, and so forth, I heard from four clients asking me to review leases for them.

One client is a raw startup that has spun out of MIT and just received its first round of venture capital financing. The second is a consulting firm that has just landed a major project. Another is a year-old development-stage company that has run out of space it had been "sharing" with another company. The fourth is a computer product maker that wants to move from Cambridge into larger and cheaper space on Route 128.

Each has particular needs that the new space must meet. Unfortunately, the language in each of their new leases consisted of dense and, in many cases, poorly drafted legalese. To make their lease review process more efficient, I faxed each of my clients a "menu" of key points to consider that many of our clients have found useful when they're thinking about leasing space.

I asked them to review the menu and put together a brief "bullet-point" list concerning their particular business needs for new space. This would help me understand what was "missing" from the standard lease documents they were being asked to sign.

Leasing new space is an event that can have major implications for any business. If a company leases space that ultimately turns out to be unsuitable for all its operations, or if the lease does not allow for expansion, the growth of the company can be unduly hindered. If too much space is leased, the company will end up wasting limited cash resources.

Lease documents can be sophisticated and complicated contracts. A great number of points beyond rent and square footage can directly and adversely affect a business tenant down the road. Conversely, a lease that provides a tenant with the right type of space and flexibility as the tenant's needs change can become an asset and provide a competitive advantage.

A prospective tenant might want to consider the following when entering into a lease.

The Premises.

Do you know, exactly, what you are leasing? A precise plan ought to be attached to your lease. The exact square footage of the premises also should be set forth. In the event future space needs are indefinite, an option to expand into, or a right of first refusal on, additional space should be considered, as well as an ability to downsize and give back space or reduce the lease term. If you are leasing a substantial portion of the building, an option or right of first refusal to purchase the building may be appropriate.

Storage/Parking.

Your lease should identify storage space and number of parking spaces, their location, their additional cost, if any, and whether parking spaces are assigned or used in common with other tenants.

Identity of the Tenant.

If you operate your business in a form other than a corporation (such as a partnership or a trust), non-recourse language should be requested. All efforts should be made to avoid entering into the lease in the name of an individual. Similarly, personal guarantees should be avoided whenever possible.

Permitted Uses.

The permitted use clause, if any, ought to be broadly drafted so as to permit all contemplated uses of the premises and incidental uses (including uses of potential subtenants). These uses should be checked against local zoning.

Initial Tenant Improvements.

Unless the space is to be taken "as is," perhaps the most significant item to be explored is the nature, timing, and responsibility for the performance and cost of the improvements to be constructed.

Operating Expenses.

If you are going to share in the cost of operating expenses for the building, you should try to exclude capital items. You will generally benefit from operating expenses being determined in accordance with generally accepted accounting principles with carefully enumerated included and excluded costs. If operating expenses are to be paid over a base, that base should, if possible, be the first full calendar year during which the lease is in effect, and the base should be "grossed up" to reflect full occupancy. Consideration should be given to negotiating a cap on increases in operating expenses during the lease term.

Maintenance and Building Services.

Your lease ought to include detailed times and standards for building services, and set forth the additional cost, if any, for off-hours or additional services, such as weekend or evening air conditioning or heating. You may wish to negotiate an abatement of the rent or lease termination right in the event an interruption of services continues for a specified time period.

Insurance.

The lease should include a covenant by the landlord to insure the building for its full replacement cost and should include a waiver of claims by the landlord for any damage covered by insurance—as well as a commitment by the landlord to obtain a waiver of subrogation from its insurer.

Tenant Default.

You should receive written notice of any default, including non-payment of rent or additional rent. The grace period after notice should be not less than five days for monetary defaults and 30 days for non-monetary defaults. The landlord should only be able to pursue remedies under the lease after notice and expiration of applicable grace periods.

Title Issues.

A non-disturbance agreement should be requested from each present mortgagee, and the landlord ought to agree to obtain such an agreement from all future mortgagees, if the lease is to be subordinate to such mortgages. Otherwise, if the landlord's lender were to foreclose on its mortgage, you might find your lease terminated by that foreclosure.

In Massachusetts, if the term of the lease, including all extension rights, exceeds seven years, a notice of lease must be recorded to assure protection of the tenant's leasehold interest from invalidation by mortgagees or purchaser who have no notice of the lease.

Special thanks goes to Warren Heilbronner of Sullivan & Worcester LLP for his work on the original leasing menu.

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